Alberta Heritage Savings Trust Fund

BUSINESS PLAN 2005-08

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The Business Plan was reviewed and approved by Treasury Board on February 18, 2005, and by the Legislature's Standing Committee on the Alberta Heritage Savings Trust Fund on March 14, 2005.

INTRODUCTION

This is the ninth business plan for the Alberta Heritage Savings Trust Fund (Heritage Fund), which amends the previous business plans and incorporates updated financial information and income forecasts. The plan sets out specific investment objectives, goals and strategies to achieve the Heritage Fund's objectives as expressed in the legislation.

MISSION

The mission of the Heritage Fund is to provide prudent stewardship of the savings from Alberta's non-renewable resources by providing the greatest financial returns on those savings for current and future generations of Albertans.[1]

BACKGROUND AND FISCAL CONTEXT

- The Heritage Fund was created in 1976 to save a portion of non-renewable resource revenue. The Heritage Fund grew from a portion of Alberta's oil and gas revenue being deposited into the Fund from inception until 1987. As well, prior to 1982, the Heritage Fund retained its income.

- On January 1, 1997, the Heritage Fund was restructured in response to a public review and, after a transition period, is now an endowment fund. The restructuring included a new governance structure as well as the establishment of new investment objectives and performance measures.

- Public consultation on the future mandate of the Heritage Fund was conducted in the form of a survey mailed to all Alberta households in 2002. The survey confirmed the importance of the Heritage Fund as an endowment, underscoring the need to preserve its real value over the long term.

- Assets and income of the Heritage Fund are fully consolidated with the assets and revenue of the Province. Income earned during a fiscal year is transferred to the General Revenue Fund (GRF), except for any portion retained for inflation proofing.

- The *Alberta Heritage Savings Trust Fund Act* includes a provision to retain a portion of the Heritage Fund's income in the Fund to protect its real value. Until the Province's accumulated debt is eliminated, the Province has discretion in retaining income to protect the real value of the Heritage Fund. It is anticipated that sufficient assets will have been set aside to retire the Province's accumulated debt by March 31, 2005. As a result, inflation proofing will commence in 2005-06.

- The Heritage Fund is embarking on an exciting new era. Subject to legislative approval of Bill 1, the *Access to the Future Act*, additional assets will be allocated to the Access to the Future endowment within the Heritage Fund, which is targeted to reach a maximum of $3 billion. An amount equal to 4½ percent of the account will be allocated annually to Advanced Education's proposed Access to the Future Fund, as described in Bill 1, to enhance advanced education opportunities for Albertans. An initial allocation of $250 million is forecast to be made to the Heritage Fund for this purpose in 2005-06.

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1. Preamble to the *Alberta Heritage Savings Trust Fund Act*.

HERITAGE FUND STRUCTURE AND INVESTMENT OBJECTIVE

The *Alberta Heritage Savings Trust Fund Act* created an endowment with the objective of maximizing long-term financial returns. The Act requires the Minister of Finance, when making investments, to adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return that will enable the endowment to meet its objectives.

GOALS, INVESTMENT STRATEGIES, OUTCOMES AND PERFORMANCE MEASURES

GOAL ONE

Preserve the real value of assets

What it means The *Alberta Heritage Savings Trust Fund Act* provides for the maintenance of the Fund's real value by requiring the Heritage Fund to be inflation-proofed once the accumulated debt of the Province is eliminated. Investments made within the Endowment Portfolio must be made with the objective of maximizing long-term financial returns. Equities have typically provided investors with higher historical total returns (current income and capital appreciation) than fixed income investments, and therefore constitute a significant proportion of the portfolio.

GOAL TWO

Achieve budgeted cumulative income forecasts during a 5-year planning horizon

What it means The government reports its financial statements on a consolidated basis and therefore Heritage Fund income is included in consolidated revenue of the province. Consequently, the level and variability of Heritage Fund income is important to the government's fiscal plan. However, the benefit of long-term capital appreciation is also desired.

The Heritage Fund is invested in a diversified portfolio that includes interest-bearing securities, Canadian equities, international equities, private equities, absolute return strategies and real estate. The Fund is invested to generate long-term returns to assist in supporting the Province's income and spending needs. It is widely accepted that a prudent mix of interest-bearing securities, equities, real estate and alternate asset classes best achieves the objective of optimizing financial returns as it provides enhanced expected returns and diversifies risk. While income may fluctuate from year to year, over a five-year period it is reasonable to expect income targets to be met.

The following strategies, expected outcomes and performance measures pertain to both Goals 1 and 2.

Strategies

- Implement the policy asset mix below:

TABLE 1: 2005-08 Business Plan

	Dec. 31, 2004 Actual	2005-08 Business Plan Policy Portfolio			
		2004-05	2005-06	2006-07	2007-08
Money Market	1.0%	2%	2%	2%	2%
Bonds	31.5%	33%	33%	30.5%	30.5%
Canadian Public Equities	20.1%	–	–	15%	15%
U.S. Public Equities	15.1%	–	–	15%	15%
Non-North American Public Equities	16.8%	–	–	15%	15%
Total Public Equities	52.0%	46%	45%	45%	45%
Private Equities	1.7%	4%	5%	5%	5%
Real Estate	9.0%	10%	10%	10%	10%
Absolute Return Strategies	4.8%	5%	5%	7.5%	7.5%
Total	100.0%	100%	100%	100%	100%
Active Currency Overlay[1]	0.0%	0%	5%	5%	5%
Absolute Return Strategies Overlay[2]	n/a	n/a	5%	5%	5%

1 Allocations to active currency overlays are shown as targeted notional exposure. These strategies have notional exposure to various currencies, but generally have near zero net exposure.

2 Absolute return strategy overlays are investments in absolute return strategies that are used in conjunction with public equity indices to enhance portfolio returns.

- Increase investments in absolute return strategies and private equity.

  Increasing exposure to non-traditional asset classes (absolute return strategies and private equity) can create a portfolio with improved risk/return trade-offs even after the additional investment costs associated with these assets are taken into account. An increased exposure to non-traditional asset classes is in line with the policies of other North American endowment funds.

- Reduce Canadian fixed income and public equity investments.

  These investments will be gradually reduced to accommodate the increase in absolute return strategies.

- Review and, if deemed appropriate, add investments in timber to potentially enhance overall portfolio return and diversification.

  During the fiscal year, timber will be reviewed as a potential asset class for inclusion in the portfolio.

- Vary the allocation of assets to enhance returns.

  Based on the outlook for financial markets, Alberta Investment Management may vary the allocation of liquid assets to enhance returns.

- Reduce the Heritage Fund's investment in project loans.

  Remaining project loans have a total value at cost of $93 million or 0.8% of Heritage Fund fair value. The largest of these project loans is a $91 million loan to Ridley Grain Ltd.

- Retain a portion of income so that the Heritage Fund grows with inflation over time.

- Remove remaining foreign property restrictions.

Expected Outcomes

- Income forecasts are achieved on a cumulative basis over five years.
- Real value of assets is preserved over a 20-year horizon.
- The Heritage Fund policy asset mix is expected to generate a real rate of return of 4.5% at an acceptable level of risk over a moving five-year period.
- Active management will add further value to the total rate of return.

Performance Measures

- The market value rate of return of the policy benchmark will be compared against the Consumer Price Index (CPI) plus 4.5% to determine whether the investment policy is achieving the returns expected based on long-term capital market assumptions.
- The actual market value rate of return will be compared against the policy benchmark return to determine the impact of fund management on performance using the following benchmarks for each asset class. Alberta Investment Management will seek to add 50 bps (0.50%) of value per year (after fees are deducted) over a five-year investment horizon.

Asset Class	Benchmark[2]
Fixed Income	
Money Market	Scotia Capital Markets 91-Day Treasury Bill Index
Bonds	Scotia Capital Markets Universe Bond Index
Equity	
Canadian	Standard & Poor's / TSX Composite Index
U.S.	Standard & Poor's Composite 1500 Index
Non-North American	Morgan Stanley Capital International Europe, Australasia, Far East Index
Private	Consumer Price Index + 8%
Real Estate	Investment Property Databank Large Institutional Property Index
Absolute Return Strategies[3]	Consumer Price Index + 6%

The above benchmarks are unchanged from the previous business plan except that the real estate benchmark is to be changed from CPI + 5% to the Investment Property Databank Large Institutional Property Index.

RISKS TO GOALS, INVESTMENT STRATEGIES, OUTCOMES AND PERFORMANCE MEASURES

Investment returns and income will vary significantly from year to year for the following reasons:

- The well-established capital market principle that increased expected returns are accompanied by increased risk.

- An investment policy to maximize long-term returns implies a weighting towards investments in equities. Equities have historically provided investors with higher total returns (dividends and capital gains) than fixed income investments; however, dividend rates in general are lower than interest rates. An equity portfolio will provide lower current income while the magnitude and timing of realizing capital gains is uncertain.

- Given a well-implemented private equities program, private equities can provide investment returns above those of public equities. However, by their nature, private equity investments are highly illiquid and are associated with an investment horizon of five to ten years to realize investment gains. Some private equity investments are subject to potentially large or total investment losses.

- Absolute returns strategies have gained prominence in recent years with an expectation of stable returns. However, this market is very fragmented, with many different strategies and investment fees above those of traditional managers. In some cases, there have been large losses sustained in the industry by otherwise well informed and highly professional investors. Manager selection and oversight are therefore critical to successful implementation.

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[2] See Appendix A for a description of these benchmarks.

[3] See Appendix C for a description of this asset class.

ACCOUNTABILITY TO ALBERTANS

GOAL THREE

Ensure the transparency of the Heritage Fund's objectives and results for Albertans

What it means Results from the Looking Forward survey confirm Albertans want a strong, healthy Heritage Fund that is used primarily for savings. Ongoing communication through published reports and news releases will ensure Albertans remain aware of the performance of the Heritage Fund.

Strategies

- Release quarterly and annual reports on a timely basis in simple, understandable language.
- Release summary reports of the Heritage Fund's investment activities and results for Albertans on a timely basis.
- Publish the Heritage Fund Business Plan annually.
- The Legislature's Standing Committee will hold annual public accountability meetings around Alberta to report on the Heritage Fund's results and to answer questions on the Fund's performance.

Expected Outcome

- Improved understanding by Albertans of the management, operations, investment philosophy and performance of the Heritage Fund.

Performance Measures

- Timeliness of reports and public accountability meetings.
- Knowledge of Albertans regarding information provided about the Heritage Fund.
- Annual report will be released by June 30 of each year.
- Quarterly reports will be released within two months after the conclusion of the quarter.
- Albertans are satisfied with their knowledge of the Heritage Fund, with 50% able to estimate the Fund's value.

MANAGEMENT AND ACCOUNTABILITY

- The mission and investment objectives for the Heritage Fund have been established in legislation and are summarized above.

- A Standing Committee of the Legislature has been created by legislation and has the following responsibilities:

  - To review and approve annually the business plan for the Heritage Fund;
  - To receive and review quarterly reports on the operation and results of the Heritage Fund;
  - To approve the annual report of the Heritage Fund;
  - To review after each fiscal year end the performance of the Heritage Fund and report to the Legislature as to whether the mission of the Heritage Fund is being fulfilled; and
  - To hold public meetings with Albertans on the investment activities and results of the Heritage Fund.

- The Minister of Finance is responsible for the operation of the Fund.

- The Endowment Fund Policy Committee reviews and recommends the business plan, quarterly and annual reports, and the investment policies for the Heritage Fund to the Minister of Finance. The Committee includes a majority of private sector members with relevant financial and business expertise.

- Alberta Investment Management, the investment operations group of Alberta Finance, makes ongoing investment decisions.

- The Auditor General is the auditor of the Heritage Fund.

- There are restrictions on the kind of investments that can be made. Heritage Fund assets are to be invested prudently and cannot be used for economic development or social investment purposes.

INCOME AND EXPENSES

- Capital gains and losses on traditional investments are not recognized as income until the investment is sold or, given a significant loss, written down. Therefore, gains and losses that are included in reported rates of return may not be immediately reflected in realized income. In contrast, income and expenses on equity index swaps are accrued as earned, resulting in gains and losses being realized in income as they occur.

The income projections include:

- Interest income;
- Dividend income;
- Capital gains or losses only when they are realized, such as when an investment is sold or written down; and
- Income and expense on index swaps and interest rate swaps accrued as earned.

- The income projections do not include unrealized capital gains.

- Following are current projections of Heritage Fund income based on the assumptions noted. Actual results will vary from projected income depending on the extent to which actual interest rates and equity market returns vary from the assumptions used.

TABLE 2: Heritage Fund Income Forecasts

	2004-05	2005-06	2006-07	2007-08
Forecast Annual Income ($millions)				
Unconsolidated Investment Income	1,030	684	695	712
Consolidated Investment Income	1,014	669	682	700
Amounts Retained for Inflation Proofing*	0	215	224	228
Transfer to General Revenue Fund	1,030	468	471	483
Forecast Fair Value of the Fund ($billions)	11.7	12.2	12.5	12.9

* Inflation-proofing to commence in 2005-06

TABLE 3: Asset Mix Assumptions

	2004-05	2005-06	2006-07	2007-08
Money Market	2%	2%	2%	2%
Bonds	33%	33%	30.5%	30.5%
Public Equities	46%	46%	45%	45%
Private Equities	4%	4%	5%	5%
Real Estate	10%	10%	10%	10%
Absolute Return Strategies	5%	5%	7.5%	7.5%

TABLE 4: Capital Market Rate of Return Expectations

	2004-05	2005-06	2006-07	2007-08
10-year Bond Rate	4.6%	4.95%	5.5%	6.0%
Canadian Public Equities	7.0%	7.0%	7.0%	7.0%
Foreign Public Equities	8.0%	8.0%	8.0%	8.0%
Alternative Investments	8.5%	8.5%	8.5%	8.5%

RISKS TO THE INVESTMENT INCOME FORECAST

1. If equity returns are lower than assumed, accounting investment income will be lower depending on the extent of the decrease in equity returns and the amount of turnover in the equity portion of the Heritage Fund.

2. If interest rates increase, the market price of bonds held by the Heritage Fund would typically decline. Accounting investment income will decrease depending on the extent of the interest rate increase and the amount of turnover in the fixed income portion of the Heritage Fund.

EXPENSE FORECAST

The preceding projections for the Heritage Fund are gross of estimated direct investment expenses. Estimated investment expenses are as follows:

TABLE 5: Heritage Fund Expense Forecasts

	2004-05	2005-06	2006-07	2007-08
		($ millions)		
Direct Management Costs	2.8	3.2	3.3	3.4
Externally Managed Investment Pools	14.7	15.6	17.7	21.2
Internally Managed Investment Pools	4.6	6.4	6.9	7.2
TOTAL	**22.1**	**25.2**	**27.9**	**31.8**
As a % of Fair Value	0.18%	0.20%	0.22%	0.24%

The administrative expenses include both direct and indirect administrative expenses, which include staff time, supplies and services, investment service costs and advisory services.

The increase in costs is due to increased staff and systems costs, increased size of the fund, and increased allocation to non-traditional asset classes (absolute return strategies and private equity) which are more costly to manage.

As of December 31, 2004, approximately 68 per cent of the Heritage Fund's assets were internally managed.

APPENDIX A

Description of Benchmark Indices for the Heritage Fund

Scotia Capital 91-day T-Bills Index (SC T-Bills Index)
Reflects the performance of the Canadian money market as measured by investments in 91-day Treasury Bills.

Scotia Capital Universe Bond Index (SC Universe Index)
Covers marketable investment-grade Canadian bonds with terms to maturity of more than one year. The purpose of this index is to reflect performance of the broad Canadian bond market in a manner similar to the way the S&P/TSX represents the Canadian equity market.

S&P/TSX Composite Index (S&P/TSX)
An index maintained by the S&P/TSX Canadian Index Policy Committee that measures the total return on the largest companies that trade on the Toronto Stock Exchange. (Formerly the TSE 300)

Standard & Poor's 500 Index (S&P 500 Index)
Covers 500 industrial, utility, transportation and financial companies of the US markets. It is a capitalization-weighted index calculated on a total return basis with dividends reinvested.

Standard & Poor's 1500 Index (S&P 1500 Index)
The S&P 1500 index is a compilation of the S&P 500 large-cap, S&P 400 mid-cap and the S&P 600 small-cap indices. This combination addresses the needs of investors wanting broader exposure, beyond the S&P 500. The S&P 1500 covers approximately 90% of investable U.S. equities.

Morgan Stanley Capital International Europe, Australasia, Far East Index (MSCI EAFE Index)
An index of over 1,000 securities listed on the stock exchanges of countries in Europe, Australasia and the Far East. The index is calculated on a total return basis, which includes re-investment of gross dividends before deduction of withholding taxes.

Consumer Price Index (CPI)
Base year 1992. Provides a broad measure of the cost of living in Canada. Tracks the retail price of a representative shopping basket of about 600 goods and services from an average household's expenditure of food, housing, transportation, furniture, clothing and recreation. All data figures that use CPI are lagged by 1 month.

IPD Large Institutional All Property Index
An index maintained by the Institute of Canadian Real Estate Investment Managers / International Property Databank that measures the total return from six large Canadian funds, which have real estate portfolios valued greater than $1.5 billion. The index is also prepared on a Held Property basis.

APPENDIX B

Business Plan Performance

Heritage Fund (Combined)[1]
Period ending December 31, 2004

	Current Quarter	Nine Months	One Year	Four Years[2]
Actual Return	5.3%	5.6%	9.5%	4.3%

Endowment Portfolio
Period ending December 31, 2004

	Current Quarter	Nine Months	One Year	Four Years[2]
Actual Return	5.3%	5.6%	9.5%	3.1%
Benchmark Return	5.0%	5.0%	9.0%	2.8%
Over (under) Benchmark	0.3%	0.6%	0.5%	0.3%

		Rates of Return			
Actual	Actual Weight	Current Quarter	Nine Months	One Year	Four Years[2]
Short-term Fixed Income	1.0%	0.6%	1.6%	2.2%	3.7%
Long-term Fixed Income	31.5%	3.2%	4.3%	7.8%	8.8%
Canadian Public Equities	20.1%	7.7%	10.4%	15.2%	4.3%
US Public Equities	15.1%	4.6%	(0.1%)	3.2%	(5.3%)
Non-North American Public Equities	16.8%	9.9%	6.7%	12.2%	(4.7%)
Real Estate	9.0%	2.9%	7.8%	10.6%	8.4%
Absolute Return Strategies	4.8%	3.4%	3.3%	6.2%	N/A
Private Equities	1.3%	(0.1%)	4.2%	4.6%	N/A
Private Income	2.9%	3.6%	7.8%	9.9%	N/A

Benchmark	Long-term Policy Weight	Current Quarter	Nine Months	One Year	Four Years[2]
Short-term fixed income (SC 91 Day T-Bill)	2.0%	0.6%	1.6%	2.3%	3.6%
Long-term fixed income (SC Universe Bond Index)	30.5%	3.1%	3.9%	7.1%	8.2%
Canadian public equities (S&P/TSX Index)	15.0%	7.2%	9.2%	14.5%	3.6%
US public equities (S&P 1500 Index)[3]	15.0%	4.4%	0.5%	3.7%	(5.8)%
Non-North American public equities (MSCI EAFE Index)	15.0%	9.8%	5.9%	12.0%	(4.8)%
Real estate (CPI plus 5.0%)[4]	10.0%	1.9%	5.7%	7.5%	9.1%
Absolute return strategies (CPI plus 6.0%)	7.5%	2.2%	6.5%	8.5%	N/A
Private equities (CPI plus 8.0%)	5.0%	2.6%	7.9%	10.5%	N/A

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1 The Transition Portfolio was wound up in the first half of 2002-03. The combined Heritage Fund return includes the past performance of the Transition Portfolio.

2 Annualized.

3 Effective April 1, 2004, the benchmark index for US equities changed from the S&P 500 to the S&P 1500.

4 Effective April 1, 2003, the benchmark return for real estate changed from the Russell Canadian Property Index to CPI plus 5.0%.

APPENDIX C

Glossary

Absolute Return Strategy
Absolute Return Strategies encompass a wide variety of investments with the objective of realizing positive returns regardless of the overall market direction. A common feature of many of these strategies is buying undervalued securities and selling short overvalued securities. Some of the major types of strategies include long/short equity, fixed income arbitrage, merger arbitrage, macroeconomic strategies, convertible arbitrage, distressed securities and short selling.

Active Management
Attempts to achieve portfolio returns greater than a specific index while controlling risk, either by forecasting broad market trends or by identifying particular mispriced sectors of a market or securities in a market.

Asset Allocation
The investment process by which the investment manager chooses or allocates funds among broad Asset Classes such as stocks and bonds.

Asset-Backed Securities
These are debt instruments collateralized by a pool of assets such as automobile loans or equipment leases.

Asset (or Investment) Class
Refers to a broad category of investments with similar characteristics (the typical asset classes are cash, stocks, bonds and real estate).

Benchmark Index
A Benchmark Index is a statistical yardstick tracking the ups and downs of a particular market by monitoring a representative group of securities over time. For example, the Scotia Capital Universe Bond Index is a benchmark index that is designed to reflect the changes in the Canadian bond market.

Bond
A bond is a financial instrument representing a debt where the issuer (corporation or government) promises to pay to the holder a specific rate of interest over the life of the bond. On the bond's maturity date, the principal is repaid in full to the holder.

Capital Gain (or Capital Loss)
The market value received on the sale of an asset, which is higher (lower) than its purchase price (also called cost or book value). If an asset is bought for $50 and sold for $75, the realized capital gain or profit is $25.

Diversification
Diversification is a process of allocation of investment assets within an Asset Class and among asset classes. In general, the greater the number of holdings within an asset class and among asset classes, the greater the diversification, which reduces risk.

Dividends
Earnings distributed to shareholders of a company, proportionate to their ownership interest.

Duration (or Modified Duration)
Modified duration is a measure of price volatility and is the weighted average term to maturity of the security's cash flows (i.e., interest and principal), with weights proportional to the present value of the cash flows. Bonds with a longer duration are more price-sensitive to interest rate changes than bonds with short durations.

Equities
Equities are synonymously called stocks or shares and represent an ownership interest in a company (could be either a public or private firm). The shareholder normally has voting rights and may receive dividends based on their proportionate ownership.

Inflation
Increases in the general price level of goods and services. Inflation is one of the major risks to investors over the long-term as savings may actually buy less in the future.

Interest-Bearing Securities
An investment that is required to pay a fixed interest rate at periodic intervals such as bonds, mortgages and debentures.

Investment Grade
An investment grade bond is rated a minimum of BBB (or equivalent) by a rating agency, with AAA being the highest grade. Bonds rated below BBB are generally classified as being speculative grade and carry higher levels of credit risk than investment grade bonds (i.e., they have a higher probability of default on interest or principal payments).

Long-term
A long-term investment horizon in the context of the Heritage Fund means a period of time that would include two business cycles, which would generally mean about 10 years.

Market Value Rate of Return
An annual percentage, which measures the total proceeds, returned to the investor per dollar invested. Total proceeds for market value rates of return = "money in the bank" plus paper profits or losses (paper profits or losses are also called Unrealized Capital Gains or Losses). "Money in the bank" means cash interest and dividends and realized capital gains or losses from selling the investment.

Median Return
The median return of a group of investment managers reflects the return associated with the manager ranked at the 50th percentile (the 50th percentile is that point where half the managers had a higher return, and half the managers had a lower return).

Money Market Instruments
Debt instruments such as Treasury Bills or corporate paper with a maturity of less than one year.

Mortgage-Backed Securities (MBS)
An MBS is a debt instrument that has an ownership claim in a pool of mortgages or an obligation that is secured by such a pool.

Mortgage Investment
A mortgage investment is a debt instrument collateralized by real assets (e.g., a building) and requiring periodic payments consisting of interest and principal.

Nominal Rate of Return
A measure of the earnings performance of a fund measured in current dollars.

Passive Management
Buying or investing in a portfolio that represents a market index without attempting to search out mispriced sectors or securities.

Portfolio
A collection of investments owned by an investor.

Private Equity
An equity investment in a private (not publicly traded) company.

Real Rate of Return
The nominal rate of return minus the rate of inflation.

Realized/Unrealized
Terms generally used to describe Capital Gains or Losses. A gain or loss is generally realized when an asset is sold; prior to sale the gain or loss is unrealized and it is only a potential or "paper" gain or loss.